

APPENDIX A
FEDERAL COMMUNICATIONS COMMISSION
Docket No. MM 92-266

**Continental Cablevision's Responses to the Proposed
Cost Accounting and Reporting Requirements in the Notice**

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The following comments concern the Commission's proposed cost accounting requirements in Subpart L of Part 76¹ and the proposed annual reporting form.² In general, Continental believes that the schedules drafted for Form 326 can be adapted to better meet the Commission's objectives and to improve the efficiency with which the data can be handled. These changes, however, would be largely technical in nature.³ The proposed cost accounting requirements, on the other hand, should be revised significantly in order to ensure that the rules are workable and realistic. Many of the terms in the rules appear to be drawn from concepts that were developed and applied with respect to Commission regulation of telephone companies. As explained in Continental's Appendix C, the cable industry differs significantly from the telephone industry. Concepts and

¹ Notice, Appendix A.

² Notice, Appendix C.

³ Continental anticipates that revisions to the proposed Form 326 may also be based in part upon the results of the survey of rate, terms and operating practices of 850 cable systems now underway. Implementation of the 1992 Act: Rate Regulation, Order, (FCC 92-545), December 23, 1992. Analysis of the data specified in the survey may help the Commission and the industry determine what data that should be collected on a continuing basis in order to satisfy the goals of the Act while not creating new regulatory reporting burdens.

terminology should not simply be borrowed from a separate industry.

Continental is able to address the proposed rules best in terms of its own chart of accounts and accounting practices. Other cable operators may utilize different accounts or a different financial reporting structure.

Section 76.701 General Accounting Requirements. The Commission proposes that virtually all types of expenses and revenues should be maintained on a "system basis." In Continental's case, accounting records generally are not kept on a system (i.e. headend) or franchise level basis. Profit and loss statements are maintained at the operations unit level. Continental has 550 franchises, 145 systems (defined by headend and 83 operations units. In most cases, these operations units embrace multiple systems and franchises. Increasingly both operations units and systems are being consolidated to improve customer service and other operating functions and to reduce costs. For example, a large operations unit can usually support longer hours of operation and more sophisticated telephone/computer systems than a smaller office can and therefore can offer better customer service.

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Like most businesses, the operations unit is fixed as the initial level of management accountability and accordingly the level where budgets are required. The budgetary level records only revenues and expenses through operating income, and certain balance sheet items such as receivables, inventory, property, plant and equipment, and certain accruals. The operations units employ, in effect, just single entry bookkeeping for management responsibility purposes. Continental currently maintains a complete balance sheet and income statement through net income (e.g., depreciation, amortization, interest, etc.) on a legal entity level i.e., company level. (Companies are usually a consolidation of several operations units under one legal entity such as Continental Cablevision of Broward County, Inc.) Double entry bookkeeping is done for each company. Continental has approximately 50 such legal entities.

The general accounting requirement should be respecified in the event that the Commission concludes that this type of cost information would be needed to set basic cable rates. If Continental were required to maintain detailed accounting records at the franchise or system level, it would increase our costs of doing business and be inconsistent with efforts to consolidate operations and improve customer service. More people and computers would be required to record, track, enter and report on

transactions at the franchise or system level.

Because these types of allocations would be imposed solely for regulatory purposes, we believe that it would be better policy to allow operators to continue to maintain their financial statements at current organizational levels, and to require additional allocations of costs only to the extent required for specific ratesetting purposes.

Section 76.701 states that "cable operators shall maintain their accounts in accordance with generally accepted accounting principles except as otherwise directed by the Commission." The exception stated in the proposed rule appears merely to mimic the rules applicable to telephone companies. The telephone company accounting system has long contained many exceptions to GAAP and over the years the Commission has sought to reduce discrepancies between USOA accounting and GAAP.⁴ Even the possibility that cable operators might be required to move away from GAAP accounting by the Commission would seem to contradict the policy direction established for telephone carriers. If the Commission were to direct cable operators to maintain accounts not in

⁴ Many discrepancies still exist between the USOA and GAAP and the Commission rules do not allow telephone companies to adopt accounting changes that incorporate GAAP without the Commission's prior approval. See 47 CFR 32.16.

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conformity with GAAP, it could result in opinion qualifications from our independent auditors. Such qualifications or accounting changes could place Continental in a position of non-compliance with bank loans and other financing agreements that are absolutely vital to the continued growth and development of the company. Most other cable operators likely would be affected similarly. The Commission should strive to keep its accounts within the scope of GAAP.

Generally, the revenue and expense categories proposed in Appendix A could be implemented. However, before it promulgates such rules the Commission should more specifically define certain terms. For instance, it is not clear whether "Other Tier" revenue should include Pay TV revenue. Significantly more guidance in the rules would likewise be required with respect to allocation of interest expense, the treatment of other expenditures that give rise to debt/interest expense (such as operating losses of a cable system that were not capitalized, inventory, supplies, etc.), and how future cash flows should be allocated between allowable and other debt.

Section 76.702 Cost Categories. The Commission's proposal appears to include all of the broadly applicable types of costs for rate base accounting. However, the special requirements of

the cable industry would require some additional detail in establishing the appropriate rate base. Currently, most costs incurred during development of new systems are not be capitalized, and are charged to expenses as operating losses. Many of these costs are associated with assets that would be used and useful in rate regulation, and such cumulative operating losses should be included in the rate base without regard. Also, calculation of net working capital should include average carrying costs of inventory and supplies since these are expenditures to build and maintain systems.

Sections 76.703 and 76.704 Joint and Common Costs and Per Channel Costs. The Commission's proposal generally incorporates the hierarchy of allocation rules applicable in Part 64 of its rules to the separation of regulated and nonregulated service costs by telephone companies. The allocation hierarchy is reasonable, but its application to the cable television industry needs to be refined. Allocation rules should be specified so as to be able to provide for different charts of accounts and different levels of aggregation.

Joint and common costs should be defined specifically within the cost structure of the cable industry. The amount of joint

and common costs should be defined as narrowly as possible.⁵

The definition of various cost levels needs to be improved, and the related allocations to the three levels of categories, detailed. Directly assigned costs for cable services are those that are a direct function of revenues, such as copyright, franchise fees, bad debt, and programming costs. Programming costs are the largest category of directly assigned costs, and most of these costs will be allocated to pay channels and satellite programming tiers. Wages and related expenses, plant maintenance, property taxes, marketing, local origination costs, depreciation, amortization, taxes, etc., would only be partly susceptible to direct and indirect cost analysis. Portions of these costs belong in the joint and common costs pool, to the extent these costs are not directly assigned to equipment or other services.

Joint and common cost allocations would be based on the ratio of direct costs assigned to at least the following service categories,⁶ if direct analysis of the origin of the costs is not possible:

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⁶ If the Commission decides not to adopt a rate benchmark system, complete cost of service allocations would, of course, require that additional categories be defined, such as Leased Access.

1. Cable services: Joint and common costs included in the cable services category would be allocated to tier services on the basis of the ratio of the number of tier-services channels used to the total number of usable activated channels over which service is being provided in the system. This amount would then be allocated to each tier service channel on the ratio of direct expenses assigned to each tier channel over total direct expenses to all tier service channels.
Advertising expenses should not be included for joint and common costs allocation.
2. Equipment installation, rental and sales: The joint and common costs category should reflect only costs not determined by a method for calculating the directly attributable costs of equipment, and outlets. Some joint and common costs are not associated with all revenues, such as overhead associated with repair of customer equipment, and allocation methods would have to be developed for such costs, to the extent directly attributed costs are not loaded for such overheads.

The Commission rules should minimize the frequency with which such costs would be reallocated. Since there are many arbitrary

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allocations required by this schedule, it is appropriate to construct the allocation schedule outside of the accounting records (e.g. on a spreadsheet) no more than once per year.

Proposed Form 326. As noted above, Continental prepares these schedules at the company (i.e., legal entity) level only, since expenses below operating cash flow and complete balance sheets normally are not maintained at the operations unit, system or franchise level. When these schedules are refined (see footnote 3, above), they should be submitted only once per year and the Commission should specify the formats and media to be used for filing the data electronically or on computer generated forms. Electronic submissions under the Commission ARMIS (automated management reporting information system) for certain telephone companies appear to be much more efficient than all-paper filing methods. We doubt that filings submitted more frequently than once per year would be useful to the Commission, because quarter-by-quarter or month-to-month variations that appear in the submissions would more likely illustrate the inherent variability of an industry, like cable, that remains in a major growth and re-development stage. The intermediate result would not indicate true trends or provide useful information.

Schedule 2. In general, each line on this schedule must be

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defined so the preparer knows what accounts comprise each line. In several instances, terminology applied in the form for classes of revenues, for example special service or regular subscriber revenues appear to be more applicable to telephone companies. In general, this form should be reworked to be more applicable to the cable industry; currently, for example cable systems do not generally utilize the term "special service" revenues. Revenues for supplement services, i.e., additional outlets, remote control handsets, guides, etc., should be combined on a single line. New expense lines should be added for major categories such as contract labor, property taxes, and vehicle expenses. On the other hand, minor categories such as common carrier microwave service and pole and duct rentals could be aggregated within a expense item such as "transport services provided by others." Line 15 should be broken down between basic and pay programming. Copyright fees should be part of basic programming. This schedule should not stop before taxes, since tax expense is part of the rate per Section 76.702.

Schedule 3. Inventory/Supplies should be included in either current assets or fixed assets. Other items on the form, such as "Plant Adjustment" and "Other Owners Equity," are not generally used in cable industry accounting. These terms should be defined, or, if possible, the items to be reported on these lines

should be aggregated with other lines.

Schedule 4. This schedule could be prepared on only a company level basis with Continental's current data. Additionally, the terminology raises a number of other questions that the Commission should clarify, if, in fact, it determines that this type of costing approach is appropriate.

Part A and C. The term "Deferred System Development Costs" needs to be precisely defined and should be consistent with the amount capitalized as pre-operating and pre-maturity costs. Similarly, the reported franchise costs should be defined so as to include deferred franchise costs as well as purchased franchises, subscriber lists and other factors that are defined as "franchise costs" by the current practices of the industry. The caption "Goodwill" should be expanded to include "Going Concern Value" as well.

Part D. As Continental noted with respect to proposed section 76.702 -.703 and -.704 above, both identified direct costs of the cable industry and the joint and common costs need to be defined with additional precision. The cost categories and definitions need to be conformed to the structure of the cable industry. For example, where Part D refers to "overhead

costs" these should be defined to include the normal allocations of corporate, regional, and operations unit management, technical support and marketing cost allocations. Continental does not utilize the term, "method used to allocate costs to system code" and does not understand this reference.

Part E. The original cost of fixed assets (sellers book value) may not be available, because financial statements are not available for some acquisitions. For example, the purchased assets may be part of a larger system or operations unit and not accounted for separately; additionally it may not be possible to reconstruct such values from historical records. Therefore, the separate entry entitled the "portion of purchase price allocated to seller's book value" may not be reportable in a meaningful way for many systems. If these terms are to be used in the Form 326 at all, cable operators should be exempted from having to report historical data and such items should only be reported starting in 1995.⁷

Part F. This form should be designed with more space for entry of all required detail.

⁷ At least a one year grace period would be required in order to allow operators to reprogram their accounting systems and practices.

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Part G. Lines 13 and 15 of this form should not be adopted without more precise definitions of owners, spouses, relatives.⁸ Ambiguities in these terms could create reporting problems; for example, Lines 15 and 16 appear to be the same. GAAP already requires footnote disclosure of related party transactions; if possible any requirements adopted by the Commission should conform to the GAAP practice in order to minimize new reporting and compliance costs imposed upon cable operators and subscribers.

⁸ This section seems to be intended only for small closely-held entities.

APPENDIX B
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**Continental Cablevision's Responses
to Appendix B "Cost of Service Standards"**

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Appendix B of the Notice poses a number of questions concerning the cost of service standards that should apply to cable rate regulation. As noted in its comments, Continental agrees with the Commission's preliminary conclusion that costs of service should not be the *primary* method for regulating rates. Continental also believes, however, that cost information is likely to play an important role for assessing cable rates in special circumstances, such as when the Commission must adjudicate a specific complaint. Almost no analysis of cable rate levels over the last few years has accounted for the impact of changes in costs occasioned by enhancements in service quality, programming diversity and technology of cable systems. Partly for this reason, reference to cost data will be important in special circumstances that cannot be reflected in a more general rate benchmark regulation plan.

Continental offers two caveats with respect to the cost of service standards discussed in Appendix B. First, in determining what cost of service methods or data shall be used to evaluate

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cable rates, the Commission should remain mindful at all times of the breadth and diversity of the industry. It may be neither feasible nor efficient to apply a single cost of service standard to the entire industry or to all matters that may require references to cost data. Second, Continental believes that many facets of the traditional rate base model (upon which Appendix B is framed) should not be applied to the cable industry.¹

Rather than adapting cable industry accounting and operating practices to the outmoded paradigms of rate base regulation, the Commission's cost of service standards for cable should instead be derived as much as possible from the practices utilized in non-regulated, market driven industries. Of course, many of the points raised in Appendix B would still be pertinent to any type of cost review of selected cable rates, but, as a general matter, Continental believes these questions should be answered through comparisons to other accounting, financial and operating conditions in non-public utility industries.

¹ The paper prepared by Economics and Technology, Inc., which is contained in Appendix C to these comments discusses in some detail (a) differences between the cable industry and the telephone companies that have been regulated via rate base/ rate of return regulation and (b) why implementing the traditional public utility model of rate regulation could impair efficient operating practices of the cable industry.

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Rate base. Paragraphs 2-7 of Appendix B concern the extent to which traditional public utility rate base accounting should be used to value the useful assets of a cable system. As ETI notes in Continental's Appendix C, a number of the rules once applied in order to define the "rate base" of large, mature telephone companies would not be feasible in the cable industry. The capital additions of cable operators represent a far larger percentage of their installed capital base.² Cable subscribership has grown much faster than telephone service penetration. Accordingly, rules that would eliminate "spare capacity" or which would exclude plant not to be placed into service within one year from "rate base" would not be appropriate for cable operations.³ Likewise, the definition of cash working capital for a cable company's rate base should be developed from a lag/lead study that incorporates current industry accounting practices.

Paragraphs 3 and 4 discuss goodwill as part of a premium established with reference to the original costs of a cable system. Goodwill is usually the residual amount after allocating

² See, Continental Appendix C, Chart 1.

³ Compare 47 CFR 65.810 - 65.830. Telephone account 2004 is excluded from the rate base definition.

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known amounts to tangible and identifiable intangible assets, such as franchise operating rights. Market analysts look at the effect of goodwill valuation as current and projected earnings streams rather than the stated book values of tangible assets.⁴ Cash flow multiples are more broadly used in financial analysis of investments rather than multiples of book value because the latter measure is more sensitive to inter-industry and inter-firm differences such as the capital intensiveness of the product function. A lower multiple of book value in a particular industry compared to a second group may merely mean that the first industry requires more capital assets to produce its output. The cable industry, built upon growth expectations and deferred gains, typically has been analyzed in terms of its cash flow multiples. Because this method of analysis is entirely unaffected by whether a particular industry or firm possesses market power,⁵ a rate regulation regime could utilize cash flow multiples in order to demonstrate that the "goodwill" of the industry is small or nonexistent. Generally, what might be

⁴ See Ciesielski, "Tapping Goodwill: It Helps Forecast a Company's Earnings, *Barron's*, October 26, 1992 page 16.

⁵ That is, while a cash flow multiple value might imply the presence or absence of market power, the method of measuring the cash flow multiple is entirely transparent to such underlying conditions of industry organization

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termed "goodwill" is really the "going concern value" for a cable system.

The "going concern value" in a cable television company represents the value of a trained work force, existing offices, contracts, systems, policies and procedures, i.e., there is a going concern so there are no start-up costs and delays. Cash flow begins immediately. This is certainly valuable to the purchaser of a business and contributes to customer service. Thus, "goodwill" is a very small percentage of the acquisition price of a cable television system and represents only about 8% of Continental's total intangible assets. The major intangible asset is the franchise operating rights, which together with going concern value and other purchased intangibles belongs in the rate base. This type of regulatory treatment is, of course, fully consistent with the Commission's recognition that "goodwill" may represent the capitalization of operating efficiencies available to the purchaser of a cable franchise but not necessarily to the seller.

The cable industry is likely to be especially subject to such

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gains when systems are acquired.⁶ These increases in economic value may include, in specific cases, lower expected investments in new reception equipment (due to consolidation of headends) and more efficient implementation of system operations.

Efficiencies have a larger effect where they allow systems to capture scale and scope economies. And the efficiency component of any "goodwill" calculation would have to be adjusted for system-specific market factors such as unserved homes or under-marketed premium services.⁷ The 1992 Act, for example, clearly delineates between the basic cable services and cable program service tiers, pay tv and pay-per-view offerings. The statute recognizes that many cable services are optional. To the extent that the acquisition price of a system also reflects the purchaser's expectation of realizing higher future revenues from these optional services, the economic value should be part of the "rate base."

⁶ The economic value is not limited merely to consolidation of adjacent systems. The same types of operating efficiencies could be realized, over time, if either the purchaser of the specific system, or the cable industry as a whole, exhibit unrealized economics or scale or scope. In that event, consolidation would help the purchaser realize savings over the time period used to value the expected cash flow.

⁷ For example, in 1986, Continental purchased four Northern California cable systems from McClatchy Newspapers for \$127.7 million or roughly \$1,420/subscriber; then a record price. As of year end 1992, Continental had increased system penetration from 41% to 58%, adding nearly 74,000 subscribers.

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Paragraphs 5 and 6 of Appendix B discuss how customer equipment should be treated in the cable system's rate base. In Appendix D, Continental presents a study by ETI which discusses the cost structure of converter equipment and additional cable outlets and presents a straightforward methodology for calculating a "cost cap" for such devices.⁸ The cost method will identify the actual cost of equipment and outlets including no more than the average level of profit ascribed to the system as a whole. Rather than being based upon a prescription of depreciation rates for these devices, the method is based directly upon the service life of converters or the average "customer life" (the period of time allowed the system operator to recover those costs attributable to a particular customer). These costs are offset by any incremental installation fees or other one-time charges in the operator's pricing plan.

If a methodology similar to the one presented by Continental were adopted by the Commission, the issue of whether or not to

⁸ The paper by Economics and Technology, Inc. is attached as Appendix D to Continental's comments. As explained in the paper, extensive analysis of cable system engineering requirements indicates that some level of recurring monthly rates for additional outlets is warranted both by cost causation principles and in order to maintain basic service rates as low as possible. This outcome is different than a simple one-time additional outlet fee which the Notice appears to contemplate.

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include these costs in rate base for basic and cable programming services would be moot. The amount of money recovered by the cable system from equipment and outlet charges would be the *lower* of either the cost cap or the actual rate levied by the operator. Under this approach, no separate rate base adjustment would be required. The revenues derived by the operator would simply be deducted from revenue requirements needed to earn the appropriate return on capital invested in other portions of the business.⁹

Cost of capital. Paragraphs 7 to 11 of Appendix B discuss how the Commission should assess the cost of capital or allowable return level for cable operators. The *Notice* seeks comment on the cable industry's cost of capital as compared to other broad groups of firms, particularly the S&P 400, and correctly states that cost of capital is based on perceived risk. Thus, the Commission seeks to compare the investing risk of the cable industry to that of average investment as measured by the S&P 400. As the Commission correctly notes, rate of return prescriptions for telephone companies have by and large carefully

⁹ As ETI notes in Appendix D hereto, the use of a direct attribution cost cap also is entirely compatible with a rate benchmark approach for essentially the same reasons: The equipment and outlet costs are calculated independently, but the resulting value is imputed to a rate benchmark in the same manner as it would be imputed to a revenue requirement based upon overall cost of service.

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evaluated costs of capital using overall financial market conditions. Using the same or similar methods, the cost of capital for cable operators should be established by comparisons to return prescriptions established for telephone companies. This market-based approach will properly account for business and financial risks faced by cable systems. The cable industry has demonstrated its ability to raise large amounts of capital very cost-effectively over many years spanning both rate regulation and deregulation. Therefore, the Commission should continue to give primary weight to capital market indicators in assessing the proper returns for cable systems and to compare these returns with the returns prescribed for telephone companies.

Continental believes that any cost of capital determination for a cable operator must account for the nature of the cable business. Any regulatory regime must consider the need to recapture already deployed capital. However, the economic fundamentals of "cash flow" businesses are wholly unlike business operated under the conventional, earnings based model. A regulatory regime such as that contemplated in Appendix B must account for these differences if it is to craft appropriate incentives. There are ample empirical data demonstrating that

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the volatility of cable shares and, by extension, the perceived risk of investing in them, substantially exceeds that of the general universe of investments.¹⁰ Confirming this conclusion is a wealth of evidence that the cost of capital for cable companies is much higher than that of public utilities, as a higher perceived risk would suggest.¹¹ This clearly disproves the notion that high valuations of some cable companies reflect a low-risk environment. Indeed, if this were so, then volatility would be low, as it is for the Regional Bell Operating Companies.

Instead, the volatility is explained by the extremely long time required for a cable company to realize on its investment and return cash to its investors. The cable subscriber has benefitted from this long term orientation because the tolerance for long term returns in fact has minimized the monthly revenues needed to provide that return. The industry's reliance on extremely long term performance intensely amplifies the exposure of such stocks to risks of changes in business conditions that will interfere with a company's ability to actually return

¹⁰ The analysis in Appendix C to Continental's comments demonstrates, among other things, that market-based measures of cable risk differ quite significantly from regulated telephone companies.

¹¹ See Appendix C to Continental's comments.